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Growth Asymmetries and Debt Threaten the Economic Recovery's Sustainability

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Growth Asymmetries

According to the most recent IMF figures (WEO, April 2010), the world economy is projected to grow by 4.2 percent in 2010, after having contracted by an estimated 0.6 percent in 2009 (in PPP rates). However, this improved outlook for the global economy hides asymmetries in the economic recovery of individual countries and regions. Such asymmetries indicate that the world economy as a whole is yet to reach a sustainable path of economic recovery.

In most emerging and developing economies growth is expected to be much stronger than in many advanced economies. Indeed, the IMF expects the group of emerging and developing countries to grow by 6.3 percent in 2010: more than two and a half times the projected 2.3 percent growth rate in advanced economies. Differences between the growth rates of advanced economies on the one hand and emerging and developing on the other hand are projected to persist in 2011. Among emerging and developing economies, developing Asia is expected to grow the fastest, with forecasts of 8.7 percent growth for both 2010 and 2011.

The weaker outlook for advanced economies is due to weak private domestic demand, high rates of unemployment, and a still fragile banking sector. By contrast, the IMF sees private demand strengthening in many emerging and developing economies, thus slowly taking on the role that fiscal policy has in many instances played in supporting activity in 2009 (see for instance Blanchard, 2010).

The asymmetric nature of the recovery presents serious challenges to the sustainability and robustness of the worldwide recovery process.

In advanced economies low growth implies fragility of the recovery. Fiscal consolidation, for instance, is urgently needed. But recovery still depends on stimulus. The delicate balance that needs to be struck implies much fragility. While fiscal stimulus is needed as a crucial cushion against weak private demand, excessive spending can threaten fiscal sustainability.

Indeed, the dramatic increase in public financing requirements already observed in some countries risks amplify the financing costs to some of these countries significantly and increase pressure on already overextended fiscal budgets. The recent crisis of Greek public finances and mounting worries over the public finances of Portugal, Spain, Italy, and Ireland have heightened fears of a renewed wave of financial contagion and of a widening sovereign-debt crisis.

Sovereign-Debt Risk is Rising

A recent study by Cecchetti et. al (BIS, 2010) draws attention to the risk of escalating public debt in several developed countries. It points to the danger that the rapid growth in current and future liabilities of governments could prove to be unsustainable and seriously undermine long-term growth and monetary stability.

The absolute level of public debt in several advanced economies is expected to reach historical record levels. This is the case, for instance, for the UK, with projected public debt levels of 111 percent of GDP by 2011. According to the OECD, total industrialized country public sector debt is now expected to exceed 100 percent of GDP in 2011. This is in contrast to public debt in emerging economies, which stands at around 40 percent of GDP on average.

The high absolute level of public debt in many advanced economies, accompanied by growing fiscal deficits, raises concerns about the ability of these countries to re-pay their debt. This situation is aggravated by the fact that many advanced economies also face the challenges that an ageing population implies for future streams of government revenues and expenditures. Furthermore, in many advanced economies unemployment remains high and the growth outlook is weak. Lastly, while real borrowing rates have so far remained low in some advanced economies, in others borrowing costs have risen sharply. This toxic mix of high levels of debt, fiscal unsustainability, potentially escalating borrowing and refinancing costs, and depressed growth - and hence revenue - raises the specter of soaring debt-to-GDP ratios, debt unsustainability, and broad spillovers.

High fiscal deficits, in addition to high debt-to-GDP ratios, have already triggered a crisis in Greece. In late April, when Standard & Poor's downgraded Greek debt, they indicated that it would not be until 2017 that the euro value of Greek GDP would return to its 2008 level. As Paul Krugman pointed out (NYT 2010), this projection implied that Greece would be unable to grow out of its troubles.

The fear over Greece's inability to grow out of its debt was clearly reflected in the spread in the yield of the Greek over the German 10-year bond. The spread jumped from around 1.3 percent in October 2009 to close to 9.8 percent in May 2010. Initially interpreted to be a short-term liquidity crisis by some economists, the Greek crisis is now seen as a solvency crisis. Greece's membership in the eurozone brings additional complications, including limitations on the use of the currency as a monetary tool in the crisis and contagion of Greece's problems to the other members of the monetary union.

Effects of the Advanced Economies' Sovereign-Debt Crisis on Developing Economies

It is still unclear what the spillover effect of the Greek crisis on the world's financial and economic system will be. However, there are strong indications that the generally high levels of public debt in the advanced world imply that the world economy will face an extended period of time with low growth rates:

- In a March 2010 speech, John Lipsky, First Deputy Managing Director of the IMF, warned that “over the medium term, large public debts could lead to high real interest rates and slower growth.” Early 2010 IMF estimates suggested that in order to maintain public debt at its post-crisis levels, potential growth in advanced economies could be reduced by as much as 0.5 percentage points annually.
- Efforts to reduce large public debts, on the other hand, require fiscal adjustments. Considering the weak economic outlook in advanced economies and the consequently limited ability of countries to raise tax revenues in order to adjust their balances, fiscal adjustments would ultimately imply spending cuts. But amid a weak economic recovery, restrictive fiscal measures would only prolong the period of weak recovery and slow growth.
- Another possibility to reduce debt would be inflation: if countries can neither pay for their debt because of fiscal constraints, nor borrow because rates are too high, they could print money – with inflationary consequences. Lipsky (2010) argues that a moderate increase in inflation would have only a limited impact on real debt burdens, “while accelerating inflation would impose major economic costs and create significant risks to a sustained expansion.”

The medium-term prospect of an extended period of slow growth in advanced economies will have implications for the developing world. The economic impact will be larger for developing economies where growth has been more heavily dependent on the external sector. While these economies, and China in particular, may continue efforts to unleash domestic markets, it is unlikely that the transition from the external to the domestic sector as an engine of growth will be fast enough to escape the reduction in international demand from weaker advanced economies.

As was the case in 2008 and 2009, it is misleading to think that developing economies will be able to entirely counterbalance a potential further weakening of demand from advanced economies. As an illustration, and based on growth figures from the UN for 2009 published in January 2010, we estimated that developing countries contributed around 0.5 percentage points to world growth in 2009, almost all of which can be attributed to China. In other words,

China's impressive growth of over 8.7% in 2009, only resulted in lowering the rate of global contraction from -2.6 to -2.0 percent.

Although we estimate that developing countries contributed more than 70 percent of world economic growth between 2005 and 2008 (see Figure 2), advanced economies still represent a very large share of the world's economy. In 2009, this share, measured at market exchange rates, was an estimated 75 percent (measured in PPP, it was an estimated 57 percent (see Figure 1)).

The importance of advanced economies is also seen in trade. Recent figures from the UN (May 2010, WESP Monthly Briefing) suggest that in the first two months of 2010 aggregate export volumes in developed regions were still 14 percent lower than they were two years ago. Despite the almost complete recovery of developing country exports to pre-crisis levels, UN/DESA does not expect a return of global trade to pre-crisis levels anytime soon.

Apart from its implications for growth, the spreading of the debt crisis could also impact developing countries through other channels. These include exchange rate volatility, which has implications for trade competitiveness and the value of foreign reserves, as well as renewed disruptions to the global banking system and financial flows with potential implications for trade finance and aid. Increased volatility in financial markets would also affect credit markets and delay decision-making - with negative implications for investment and growth in both developing and developed countries.

There are economists who believe that a mounting crisis in advanced economies in a context of low levels of public debt in some emerging markets could in fact favor some developing economies in terms of global asset flows over the long-term (see for instance Toloui 2010). This is because lower levels of debt in the developing world would allow some countries to continue on a path of higher economic growth and greater economic dynamism. Developing countries most likely to benefit from this scenario are those that carry low public and private debt and are relatively less dependent on the external sector.

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| Share of the World GDP (market prices, constant 2000 US\$) | | | |
|---|-------------|-------------|--------------|
| | 1960 | 1990 | 2009P |
| United States | 35% | 29% | 29% |
| Japan | 9% | 17% | 12% |
| EU 15 | 33% | 28% | 23% |
| Other high income | 8% | 9% | 11% |
| Low & Middle income | 15% | 17% | 25% |
| China | 1% | 2% | 7% |
| India | 1% | 1% | 2% |
| Soviet Union - CIS | .. | 2% | 1% |
| LDC | .. | 1% | 1% |
| Share of the World GDP (PPP, constant 2005 US\$) | | | |
| | 1960 | 1990 | 2008 |
| United States | 24% | 21% | 20% |
| Japan | 4% | 8% | 6% |
| EU 15 | 25% | 23% | 19% |
| Other high income | 7% | 8% | 11% |
| Low & Middle income | 38% | 38% | 43% |
| China | 5% | 5% | 11% |
| India | 4% | 4% | 5% |
| Soviet Union - CIS | 10% | 7% | 5% |
| LDC | 2% | 2% | 2% |

Figure 1 Share of the World's GDP, 1960 – 2009E

Source: Own computation based on the World Bank's World Development Indicator. Growth projections for 2009 are based on UN DESA World Economic Situation and Prospects (WESP, May 2010).

| Contributions to the World's Growth (market prices, constant 2000 US\$) | | | |
|--|------------------|-------------------|-------------------|
| | 1960-1990 | 1990-2009E | 2005-2009P |
| United States | 27% | 27% | 11% |
| Japan | 20% | 5% | -3% |
| EU 15 | 26% | 15% | 6% |
| Other high income | 9% | 15% | 13% |
| Low & Middle income | 18% | 37% | 73% |
| China | 2% | 16% | 34% |
| India | 1% | 4% | 8% |
| Soviet Union - CIS | .. | 0% | 3% |
| LDC | .. | 1% | 3% |
| Contribution to the World's Growth (PPP, constant 2005 US\$) | | | |
| | 1960-1990 | 1990-2008 | 2005-2008 |
| United States | 20% | 18% | 9% |
| Japan | 10% | 3% | 2% |
| EU 15 | 19% | 14% | 10% |
| Other high income | 10% | 11% | 9% |
| Low & Middle income | 40% | 54% | 71% |
| China | 9% | 21% | 26% |
| India | 4% | 7% | 9% |
| Soviet Union - CIS | 6% | 1% | 7% |
| LDC | 1% | 2% | 3% |

Figure 2 Contributions to the World's Growth, 1960 – 2009E

Source: Own computation based on the World Bank's World Development Indicator. Growth projections for 2009 are based on UN DESA World Economic Situation and Prospects (WESP, May 2010).